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SUBJECT: ARGENTINA: DOMINGO CAVALLO PANS GOA POLICIES,
WARNS OF SHARP RECESSION AND SOCIAL STRIFE, SUGGESTS
SALVATION LIES WITH IMF

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Classified By: Ambassador E. Anthony Wayne for Reasons 1.4 (b,d)

Summary

¶1. (C) The post-crisis Kirchner model no longer works and Argentina is headed for "stagflation," according to controversial Argentine ex-Economy Minister Domingo Cavallo. During a meeting with the Ambassador, Cavallo suggested that returning to the IMF may be the only way to alleviate Argentina's problems, and noted the only reason for optimism is that the Kirchners are in decline and their successors are sure to do a better job. He said Peronist party leaders were already considering alternatives to the Kirchners, and a scenario certainly exists that has the Kirchners leaving office prior to 2011. Cavallo's worries about the economy and likely increase in social tension were interspersed with arguments justifying his own pre-2001 collapse decisions and blaming the 2002 pesification decrees for much of Argentina's current predicament. Cavallo also recommended the USG use the G-20 discussions to moderate the Kirchners' economic policies (reported reftel). End Summary.

Cavallo's Resurrection?

¶2. (C) For the first time since his return to Argentina in late 2006 from a self-imposed exile at Harvard University, the Ambassador held a formal (albeit low-profile) meeting with the controversial, divisive, and widely reviled ex-Economy Minister Domingo Cavallo. (Many Argentines hold Cavallo at least partially liable for the 2001/02 economic collapse. He famously introduced "convertibility" (fixing the peso one-to-one to the dollar) under President Menem in the early 1990s, and failed to pull Argentina back from the abyss during a second short stint as Minister under President de la Rúa in 2001 (during which he implemented the hated "corralito," which froze bank accounts.))

¶3. (C) Like many other notable opposition figures smelling weakness in the current administration, Cavallo has begun to take a higher profile, giving more interviews and becoming increasingly active on his widely-read blog. He recently published a book about Argentina's economy with the self-explanatory title, "stagflation," after which he hit the local talk show circuit to promote it and warn of the country's impending economic crisis. He also presented an article ("Distorting the Micro to Embellish the Macro: the Case of Argentina") at the 2008 International Financial Forum

in Beijing in mid-November on behalf of the Group of Thirty. (The G-30 is comprised of high-profile private sector individuals and focuses on deepening understanding of international economic and financial issues.) Cavallo came across as rejuvenated and enthusiastic, and seemed intent on rehabilitating his image, reputation, and legacy, and on reclaiming a role as sage on Argentine economic issues.

K'nomics Broken; Welcome to stagflation

14. (C) Cavallo dismissed the Kirchner economic model, structured around an undervalued "competitive" currency, as no longer functional. He then took pains to point out that it was really more of a "post-crisis model," which Kirchner inherited from President Duhalde and basically maintained upon taking office in 2003. Regardless of what you call it, he argued, the economic policies pursued since 2002 have taken Argentina off the reform path started in the 1990s. The countries in the hemisphere that continued with more orthodox policies begun in the 1990s or earlier, such as Brazil, Mexico, Colombia, Peru, Uruguay, and Chile, are all in better shape than is Argentina to deal with the current international crisis, he argued.

15. (C) Cavallo noted that he had elaborated on this in his paper for the G-30: the GoA has maintained a mix of heterodox, pro-cyclical policies that resulted in high growth for a number of years, but has left the country poorly positioned to respond to the global crisis. The article states that the two pillars of the K model are: 1) maintain

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an undervalued real exchange rate via sterilized intervention and capital controls to promote exports and protect local industry; and 2) generate a fiscal surplus to repress domestic inflationary pressures, while also tamping down inflation by taxing exports, freezing public utility tariffs, and negotiating "voluntary" wage and price agreements.

16. (C) Cavallo acknowledged that these policies allowed the economy to grow faster than it would have otherwise, and led to important increases in real wages and employment, which all redounded to the benefit of the Kirchners. However, the myriad market distortions introduced to keep the peso from appreciating and inflation from increasing created economy-wide microeconomic imbalances and forced the GoA to ramp up subsidies, particularly to the public transport and energy sectors. Therefore, while the Brazilian Real appreciated and the GoB's fiscal situation strengthened during the last five years of expansion, Argentina pursued highly pro-cyclical policies of a weak peso and falling fiscal surplus despite record-high growth in tax collection. So, now, when Brazil and other countries are pursuing counter-cyclical policies and allowing their currencies to depreciate in response to weak external fundamentals, the GoA has little room to do so without provoking major capital flight.

17. (C) The result, Cavallo told the Ambassador, is that Argentina now has no clear exit. The GoA has no access to credit (either international or domestic), he noted, and revenue collection is declining rapidly along with the rapid deceleration of economic growth. Therefore, especially given that the GoA will be inclined to attempt to increase spending prior to the October 2009 mid-term elections, Cavallo predicted that the GoA will see a fiscal deficit this year. Given lack of credit, the Central Bank (BCRA) will have to monetize this deficit (printing pesos), Cavallo said, and this will result in higher inflation, further pressure on the peso to depreciate, and greater capital flight. The conclusion, he predicted, given his expectation that Argentina will experience an economic contraction this year, is that the country is facing a prolonged period of stagflation. He added that this scenario is not so different

from those Argentina faced in the 1970s and 1980s, which ended in hyperinflation.

IMF as Savior, or Face Venezuelazation of Economy

18. (C) Stagflation is the premise of his new book, and Cavallo said it was painful to see inflation becoming a problem again after the Menem administration's peso pegging exercise had put an end to 50 years of high inflation and deeply ingrained inflationary expectations. His prediction that inflation will stay high in 2009 is at odds with those of many Argentine economists, who expect decelerating growth, tighter monetary policy, higher local interest rates, and lower commodity prices to put downward pressure on prices. Cavallo is convinced, however, that fiscal weakness going forward, along with the depreciating peso, will more than offset these deflationary forces.

19. (C) In particular, Cavallo noted the "repressed inflation" that exists due to price controls and export restraints. The GoA has maintained this situation by using subsidies to compensate for the negative effect on producer incentives. However, with tax revenues falling rapidly, Cavallo expects the GoA will need to continue cutting subsidies and allowing prices to increase. He disparaged the GoA's belief that the nationalization of the private pension funds (AFJPs) will provide the ready cash to continue the high level of expenditure growth of the last few years. On the contrary, Cavallo argued, half of AFJP assets were already been invested in GoA bonds, and the other half were invested in the private sector. Therefore, liquid funds available are limited, and as the GoA uses incoming pension payment flows for its own uses, it will further starve the private sector of credit. This will limit private sector growth prospects, thus reducing their tax payments. So, he argued, the net increase in revenue to the GoA of nationalizing the AFJPs will be limited, and meanwhile the action severely damaged the economy, prompted capital outflow, and completely dried up any access to credit.

110. (C) So, the GoA needs financing, but "will not follow the

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world's rules to get it," said Cavallo. He called it "crazy" that the GoA could not negotiate a debt restructuring deal with the Paris Club just because it refused to submit to the requirement of having a current IMF program. He also belittled the President's plan to pay the Paris Club with BCRA reserves, as well as the broader idea within the GoA that it can tap BCRA reserves as a source of financing. The reality, he argued, is that the BCRA is in a weaker position than it appears, given its US\$47 billion in reserves. "Reserves do not even cover 85% of the BCRA's obligations," he argued.

111. (C) The clear solution, he claimed, is to do what many other countries with easy access to IMF lending are doing. However, Argentina is not even submitting to Article IV consultations because it refuses to acknowledge that national statistics agency INDEC is tampering with inflation statistics. In television interviews, Cavallo emphasizes this point, arguing that the GoA does not want to admit that INDEC is lying about the real level of inflation, "but every Argentine knows that INDEC is lying, so the government should just admit that INDEC was lying but won't anymore."

112. (C) The alternative of not owning up to the deficiencies of the GoA's economic policies and seeking IMF financial support, Cavallo argued, is the "Venezuelazation" of the economy. In particular, he predicted the GoA and BCRA will have to impose limits on dollar purchases and parallel exchange markets will reappear. Cavallo thought that BCRA President Redrado will do everything possible to avoid this, but has increasingly limited room for maneuver. Cavallo

noted that Redrado and even Economy Minister Carlos Fernandez and new Production Minister Debora Giorgi have solid technical skills, "but that does not matter because Nestor Kirchner (NK) makes all the economic decisions and usually without consulting advisors."

Short-term Pessimist (2009-11), Long-Term Optimist

¶13. (C) Despite his pessimistic outlook for the economy, Cavallo is optimistic that the administration that follows the Kirchners will act quickly to reintegrate Argentina into the world. He argued that the experience under the two Kirchner administrations has opened most Argentines' eyes as to the dangers of being isolated from the world and of being governed by leaders with autocratic styles. "Argentina used to be considered a solid country," he claimed, "commanding worldwide respect -- and was even held in higher regard at the time than Mexico and Brazil. That was why it was included in the G-20, something that would not happen now."

¶14. (C) Cavallo noted that, ironically, NK, as Governor of Santa Cruz Province, was one of his biggest supporters during the 1990s, and as one of the most fiscally conservative Governors also fully supported the 1990s economic reforms. However, as President, NK consolidated power and increasingly used radical protest groups to maintain control. Cavallo speculated that NK is now starting to realize that this is working against the administration of his wife, President Cristina Fernandez de Kirchner (CFK), and he realizes he is losing control of these groups. However, Cavallo thought that NK does not know how to unwind the political positions he has taken, and as a result the Kirchners are increasingly politically isolated and their political power is declining. Peronist party leaders are actively looking for successors, Cavallo claimed.

¶15. (C) Cavallo remarked that "some" think NK will convince CFK to resign after their administration does poorly in the October mid-term elections, leaving it to Vice President Julio Cobos to govern the country. He argued that the "grupos de choque" (protest groups), which he labeled dangerous and potentially violent, would make Cobos' life impossible. In this scenario, he said, the best option would be for Cobos to call new elections. The other alternative is that CFK clings to power through the 2011 presidential elections, presiding over a deteriorating economy and severely weakened government.

¶16. (C) Either way, Cavallo predicted, a stronger and more globally-minded administration will eventually take over. Of the opposition, Cavallo said that Cobos and Elisa Carrio will be key figures in building a coalition, but that Senator

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Carlos Reutemann (and former Governor of Santa Fe Province) is the only unifying leader around. Senator Reutemann, he said, had been Duhalde's first choice for President in 2002, but unfortunately had declined to run at that time. (Reutemann recently broke with the Kirchner bloc in the Senate.)

Pesification, not devaluation, is root cause of problems

¶17. (C) Amidst expressing concerns about the economy and the potential for social unrest, Cavallo provided justifications for his own actions in 2001 leading up to the December 2001 financial crisis and sovereign default. He blamed much of the crisis on "a series of errors committed by the IMF," culminating in the Fund's decision not to disburse the tranche scheduled for November 2001 ("at a time when the U.S. was distracted with 9/11"). This led to then-President de la Rúa losing power. The aftermath of the devaluation and

pesification of most contracts, both of which happened after he departed the GoA, had smashed savers and aided debtors, he argued. However, he said it was pesification, which he accused of being a form of expropriation, that did the real damage that Argentina is still paying for today.

¶18. (C) The GoA implemented a series of decrees starting in January 2002, after the default and devaluation, which revalued most contracts, utility tariffs, government and province debts, and bank loans from dollars to pesos at one-to-one, even though the peso had fallen 70%. The upshot of this, Cavallo argued, was that the GoA violated millions of contracts and lost credibility with creditors and investors. He noted that Turkey had gone through a similar crisis, but had only devalued -- and had come out of it in a stronger position than had Argentina.

Comment

¶19. (C) Cavallo remains a polarizing personality in Argentina, and has limited influence or presence in the country at the moment. He also is far from being free from blame for the economic troubles Argentina has endured of the last decade. Therefore, his criticisms of the current governments policies tend to lack credibility with some Argentine audiences. Nevertheless, many of his comments on the economy seem to ring true, from Post's perspective, and there is also a growing chorus that agrees with him that the best available solution to Argentina's predicament is to make right with the IMF. End Comment.
WAYNE